



Facultad de Ciencias Económicas y Empresariales

FINAL PROJECT WORK...

UNFAIR CLAUSES IN MORTGAGE LOANS

Javier Caso Echechipía

DIRECTOR

María Teresa Hualde Manso

CO-DIRECTOR

María Teresa Goyen Urrutia

Pamplona-Iruña

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## **SUMMARY**

This Final Project focuses on mortgage loan contracts, particularly focused on their unfair terms. In order to do this, it has been tried to see what is the origin and thus cause of such terms and how they are regulated going gradually from the most general at the beginning to the most particular at the end. Firstly, it talks about the loan agreement, including all elements that comprise it with their own characteristics. Later, the emphasis is on the content of the contract, the general contracting conditions, which form what is called the adhesion contract. Then, unfair terms and the ones that usually appear on the mortgage loan contracts are defined. To conclude the study, it has been reviewed the famous "Aziz case". This case was the one that changed the Spanish foreclosure proceed.

## **KEY WORDS**

Mortgage loan contract

Unfair clauses

Court of Justice of the European Union

Early maturity

Default interests

Floor clause

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## 1. INTRODUCTION

This work has the objective of studying the unfair clauses in mortgage loan contracts. It has also the aim of assessing the economic consequences that they entail for consumers or users.

It is specifically intended to study the mortgage loan contracts between financial institutions and consumers. So there has been excluded from this study both the contracts signed among individuals and the ones signed among enterprises.

First of all, such work has started with the description of a mortgage loan contract, with all its elements and characteristics. According to the scope of this final project work, the subjects, both the debtor and the creditor are renamed borrower and lender. In the next step it has been proceeded to explain the general contracting conditions as an introduction of the next section and the most important one: the unfair clauses. After all these doctrinal definitions, to conclude the work, it has been chosen the study of a real issue, a real case. This is called "Aziz case ", where you can see the effects of unfair clauses for consumers. It has been showed also the diligence performed over the case by both the European (Court of Justice of European Union) and national courts (Commercial Court No. 3 of Barcelona Court).

The reason why this Final Project Work has been selected is because it is an affair that happens with much assiduity to consumers. It is also an issue highly relevant to the society in which we live today due to it talks about properties of average people. To realize the importance of this issue and the number of properties are affected by it, it has been obtained through the website of the General Council of the Judiciary (GCJ) different statistics about mortgage executions (also known as foreclosures).

To display some data about foreclosures, the report of the Association of Registrars presents some data in the form of tables from transactions in which the owners of the houses were individuals. Then it is also accompanied with estimation about how many of them correspond to first properties. These are the 2012 data:

	Total properties	First homes
Sarted foreclosures	65778	49202
Adjudications due to foreclosures	38976	30050

As it can be seen in the table above, during 2012 there were issued 65778 certifications of foreclosures initiation, with the 74.8% of them being first homes.

The Judicial Statistics, whose main purpose is to measure the workload of the courts, simply pick up from each trial of first instance and first instance and instruction the movement of foreclosures. For the year 2012, this agency offered the following data:

	Colected	Restarted	Accumulated	Resolved	Pending completion
Foreclosures	91622	1929	123	75375	198076

After this brief introduction, the first theoretical point of this paper deals with the origin of the problem: the mortgage loan contract.

## 2. MORTGAGE LOAN

To contextualize and locate the subject in a better way, a definition of what is a loan contract will take place according to Spanish legislation.

### 2.1. Definition

The Civil Code (hereinafter CC) regulates the loan agreement from the article 1740 to 1757 and defines it in the follow way: " For the loan agreement, one party delivers to the other, either something not fungible to use it for a while and then return it, in which case it is called comodato, or money or other consumable thing, with the condition of returning the

same thing of the same kind and quality, in which case simply retains the name of the loan."<sup>1</sup>

The CC describes two forms of loan agreement: comodato and loan. This paper addresses the second one, also called simple or consuming loan.

In this type of contract, "who borrows money or other fungible thing acquires its ownership and is obliged to return it to the creditor in the same terms: kind and quality"<sup>2</sup>. The obligation of the one who takes the money (borrower) is to return an amount equal to the received one and of the same kind and quality, even though it suffers an alteration in its original price.

As it can be observed, the CC does not require that the loan has to be remunerated. Borrowing money is free originally. The additional interests exist if there are agreed. However, in the context of the development of this paper, credit institutions undertake these contracts as part of their business, with an aim of making profit. Therefore, the loan agreements signed with these entities are remunerated through the interest that the borrower is obliged to pay for the amount borrowed.

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Just defined the loan agreement, the next step is the definition of mortgage loan. The mortgage loan contract is an agreement by which a property is offered as a guarantee that the debtor will pay the debt. Hence, if it is not returned (plus interests) on the agreed terms, the creditor can urge the sale of the property in public auction of the mortgaged property to collect what is owed. The sale of the property can be performed implementing previously the judicial or extrajudicial execution procedures established in our legislation.

The Bank of Spain (BS) defines this contract in a sense that every kind of person can understand with no problems. The goal is that all citizens can realize the scope that can reach their obligations and what may they assume through signing such kind of agreement.

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<sup>1</sup> SPAIN. 2010. Civil Code: Article 1740. 33th edition. Madrid. Civitas. SPAIN. Royal Decree of 24 July 1889 Civil Code.

<sup>2</sup> SPAIN. 2010. Civil Code. Article 1753. 33th edition. Madrid. Civitas.

"The mortgage loan is a banking product that allows you, as a client or borrower, to receive a certain amount of money (called the principal of the loan) from a credit institution (moneylender) in exchange for a commitment to repay that amount, with the corresponding interests, through periodic payments (named quotas).

Why is it called mortgage loan? That 'surname' comes due to the special guarantee that the financial institution has to recover the lent quantity: a mortgage over the property (a house or a flat, usually) which is usually mostly owned by the customer.

All kind of loans has as a generic guarantee that is the present and future assets of the debtor. But in the case of mortgage loans, if you, for example, are the person who has received the money and do not pay your debt, then the bank can make the sale of the mortgaged property in order to recover the amount you have left outstanding "<sup>3</sup>.

As we can see in this definition, the mortgage loan is money lending from the lender to the borrower (lender and consumer respectively in the field in which this work is limited). The borrower (client or consumer) receives the capital of the loan on the condition that he returns that amount, with some interests, by quotas or periodic payment throughout the duration that has been agreed with the lender. What distinguishes it from other kinds of loan is the guarantee that the bank has on the property if the borrower fails to make the payments. The bank has this in order to guarantee that if the customer does not accomplish the periodic payments of the debt, it has preference over other creditors over the property. The property (usually a house) will not be able to be transmitted if the acquirer does not know such fact insomuch as the real right of a mortgage requires registration with constitutive character. Referring to the latter phrase, the Mortgage Act, February 8, 1946 , provides in its Article 130 that: "The process of direct execution against the mortgaged properties may be exercised only as a realization of a registered mortgage on the basis of those contents in the title which has been collected in the respective book entry"<sup>4</sup>.

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<sup>3</sup> BANK OF SPAIN. 2014. <http://www.bde.es/> . Madrid: BDE. Consulting date: 11 May 2014. Available in: <http://www.bde.es/clientebanca/productos/hipotecas/quees/quees.htm>

<sup>4</sup> Decree of 8 February 1946 by which it is approved the new official redaction of the Mortgage Law. Published in BOE no. 58 27/02/1946.



In order to delve a little bit more on the subject, I will proceed to show the characteristics of the loan agreement.

## **2.2. Features**

The loan agreement gathers a number of characteristics that are common to all civil contracts.

First, it is said that the loan agreement is a real contract, since it requires the delivery of the thing given for its completion.

It is a unilateral contract, in which only the borrower has obligations. These are the bringing back of the agreed amount by periodic payments composed of both principal and interest payments. The creditor (moneylender) does not incur in any obligation.

It is onerous, since there are charges and profits for both parties. This is not a free loan. In such case, the name of the contract would be comodato.

It is considered an accessory contract, because it assumes the existence of a principal obligation whose fulfillment ensures the loan.

It is a commutative loan, that is to say, the lending the parties owe to each other is certain and determined since the beginning.

In addition, the loan agreement is principal due to it does not depend on the existence of another contract to exist by itself.

Finally, it is considered a nominee contract. This is because it has been regulated by the CC, in which it receives the specific name of mutual.

## **2.3. Elements: Subject, object, cause.**

In this section it is going to proceed to explain and detail the different elements involved in the mortgage loan contract. On the one hand, it talks about the people involved in it: the lender or credit institution and the borrower or customer. After that, on the other hand, the object and the cause of the contract will be explained.

### **2.3.1. Subjects**

The CC establishes in its article 38 that legal persons can be both creditor and debtor. As it has already mentioned in this final project work, the people involved in the contract of mortgage loan are two: the lender and the borrower. In the following lines it is explained what a lender is.

#### **2.3.1.1. Lender. Rights and obligations.**

The lender can be both a natural or legal person who gives money to anyone who borrows it. He gives it with the condition of repayment the quantity plus interests. Within the scope that concerns the present paper, the lender is a credit institution (bank or a savings bank) that lends money to the borrower in exchange that the customer will return the agreed amount plus interest in periodic payments (named quotas). Its purpose is to provide capital to the borrower in order to allow him to acquire a property.

The lender has a number of rights and obligations. These can be found in books II and IV of European Contract Law, belonging to the Draft of Common Frame of Reference<sup>5</sup>. With regard to their rights as a lender, these would be the main ones:

- Might to transfer its position as lender to a third party (without the debtor's consent needed).
- Obtain information about the destiny of the quantity lent.
- Obtain, just in case, a compensation for early repayment of the loan.
- Require to the borrower to take the loan over a reasonable time. If this fails, the lender will have the right (after a reasonable time) to either demand for the fulfillment of the obligation or to terminate the contract. In both cases the lender could seek compensation for damages and injuries.

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<sup>5</sup> VAQUER, A./BOSCH, E./SANCHEZ, M. 2005. *European contract Law, books II y IV*. Atelier libros. <http://books.google.es/books?id=3VLw6YILsQ8C&pg=PA1635&lpg=PA1635&dq=derechos+y+obligaciones+civiles+de+los+prestamistas&source=bl&ots=NCUotK-Tur&sig=C2GtpZ3tSTh-CkoRFB-aeNOIXz8&hl=es&sa=X&ei=BEmaU4brJKPz0gWyqICYDQ&ved=0CGQQ6AEwCA#v=onepage&q=derechos%20y%20obligaciones%20civiles%20de%20los%20prestamistas&f=false>

- Require refund of the amount of money borrowed by the client if not returned at the time and in the agreed form.

In addition to the rights, the lender also has obligations. Just below there is a brief list of the most important shows.

- To put in the hands of the borrower the amount of money agreed at the time of execution of the contract. This will depend on the conditions that have each contract.
- To inform the borrower about the loan on certain aspects, such as the principal or the interest included. The information must be clear, concise and understandable to the consumer or client (borrower).

#### ***2.3.1.2. Borrower: Consumer or user. Rights and obligations.***

Since in this paper we limit the concept of a borrower to meet a customer looking for satisfying a need as it is obtaining a property, the definition of consumer or user of the General Law for the Defense of Consumers and Users will be the most propitious.

The consumer or user is called borrower and is the loan's receiver. He is the debtor. But what do we mean when we use the term consumer or user? Article 2 of the General Law for the Defense of Consumers and Users (hereinafter GLDCU) dictates as follows:

"For the purposes of this Act are consumers or users the natural or legal people who purchase , use or enjoy as final receivers, real or personal property , products, services, activities or functions, whatever which is the collective public, private or individually of those who produce , facilitate , provide or issue .

There will not be considered consumers or users the ones who without becoming final recipients, acquire, store, use or consume goods or services, in order to integrate it into processes of production, processing , marketing or provision to third parties."<sup>6</sup>

From this definition we can deduce the features that requires. First of all, it is said that it must be an act of consumption that involves the use or enjoyment of a product or service

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<sup>6</sup> REYES LÓPEZ, M.J. 2009. Manual de derecho privado de consumo. 1ª edición. Madrid: La Ley. P 90.

to meet a need of a private nature. That is, outside the market: excluded from any process of industrialization, distribution or marketing.

The second requirement talks about that the act is not done for profit, in other words, for financial gain. It has to be done to meet the needs of domestic nature, independently of the market activity.

The Restated Text (RTGLDCU) provides a more concise definition. Its Article 3 dictates the following: "For purposes of this rule and without detriment of what it is disposed in its third and fourth books, there are considered consumers any natural or legal persons acting in a foreign field to a business or professional activity."<sup>7</sup>

Throughout this definition the intention is to refer to relationships that arise in the market between consumer and entrepreneur, starting from the premise that the weaker subject or the party that needs more protection by law in the operation is the consumer.

As well as the lender (the bank), the borrower (consumer) also has rights and obligations. Like the previous ones, both are included in the manual European Contract Law , in books II and IV.

Rights:

- Right to receive from the moneylender in his disposal the agreed amount in the agreed term. In the case that the lender fails to comply with this obligation, the borrower may claim the disposal the subject of the contract (the agreed amount) or terminate the contract. In both cases, the borrower may claim compensation for damages and injuries caused by this breach.

Regarding the liabilities, there would be as follows:

- Taking money borrowed, as well as which is set out in their rights, within a reasonable period. Now the money is the ownership of the borrower. The ownership is transferred from one party to the other one.
- To return the principal plus interest in the agreed way and terms.

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<sup>7</sup> Article no. 3. Royal Legislative Decree 1/2007, 16 November, by which is approved the Restated Text of the General Law For the Defense of Consumers and Users and other complementary laws. Published in BOE no. 287 30 November 2007.

### ***2.3.2. Object***

The requirements needed for the celebration of a contract are:

- "Blessing of both parties
- A definite object that is the subject of the contract
- Cause of the obligation which is established"<sup>8</sup>

The first of the three conditions is clear at all. The performance of a contract without the consent of either party is not understood. Both parties must be in accordance with the agreement.

However, the second requirement is not so clear. What do you mean by object? There is no clear definition of the subject but it can be inferred that it makes references to the things and the services to which the contract relates.

There can be subject to contract all the things that are not outside the commerce of men, even the future ones. There can also be subject to contract all services that are legal and that are not contrary to good morals. Instead of this, "they may not be subject to contract neither impossible things nor services."<sup>9</sup> The CC also stipulates that there must be a definite thing in relation to its kind and that the uncertainty in the amount will not be an impediment to the contract whenever it is possible determine.<sup>10</sup> What must be clear is what type of object (or service) is provided.

All these objectives contract requirements can be summarized in three words: possibility, legality and determination.<sup>11</sup> It must be a thing or service possible, nothing fictitious. It has

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<sup>8</sup> SPAIN. 2010. Civil Code: Article 1261. 33th edition. Madrid. Civitas.

<sup>9</sup> SPAIN, Article 1272. Royal Decree 24 July 1889. Civil Code

<sup>10</sup> SPAIN, Article 1273. Royal Decree 24 July 1889 Civil Code.

<sup>11</sup> DÍEZ-PICAZO. 2007. Fundamentals of Property Civil Law. 6<sup>th</sup> edition. Pamplona. Aranzadi. P 234.

to be legal and not contrary to good morals. And as it has already been mentioned, it has to be determined what kind of thing or service is hiring.

### **2.3.3. Cause**

The cause of an obligation is the third requirement set out in the Article 1261 of the CC<sup>12</sup> for the formation of a contract. Later, the Code states that: *"In onerous contracts the cause is understood as, for each contracting party, the lending or promise of a thing or service by the other party"*.<sup>13</sup> The Cause of the obligation must exist because there must be an origin of obligations. The cause is the source of the obligation, the legal basis for the existence of a debt.

If there is a case of a contract without cause, or a contract whose cause is illegal, there is no effect. The cause is illegal when it is against law or morality.

If the expression of a false cause is given, the nullity of the contract will occur. This may not be voidable if it is established that it was inspired or based on other real and legal cause.

Once it has been finished the explanation of what the essential elements of a contract are, the next step are the clauses that appear in it. These are called general contracting conditions.

## **3. GENERAL CONTRACTING CONDITIONS**

### **3.1. Definition**

According to the Law 7/ 1998 of 13 April on the general contracting conditions (GCCL): *"General contracting conditions are those predisposed clauses whose incorporation into the contract is imposed by one party, regardless of who has perpetrated thereof, regardless its external appearance,*

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<sup>12</sup> SPAIN. Article 1261 of Civil Code. Royal Decree 24 July 1889

<sup>13</sup> SPAIN. Article 1274 of Civil Code. Royal Decree 24 July 1889

*regardless its length and regardless any other circumstances, having been drafted in order to be incorporated into a number of contracts."*<sup>14</sup>

In accordance of what is exposed by Reyes Lopez, M. J (2009)<sup>15</sup> in his book Manual of Private Consumption Law, the peculiar features of this definition is based on two elements: the willingness and the incorporation into a several number of contracts. The trend implies that the entrepreneur, in the field that this final project work deals with, is renamed moneylender (the bank). The lender imposes the content in these contractual clauses, which are applied to a number of contracts with identical characteristics. It is what is known as an adhesion contract. The borrower (client) can only fully accept or reject them. It is irrelevant who has drafted the clauses (the employer or other person), its location within the contract, the name that is given to the contract, its way of drafting or otherwise. Even if it happens that one or more clauses have been dealt individually, the application of the Law does not exclude the rest of the clauses. It can happen if the general appreciation is that it is an adhesion contract or agreement.

### **3.2. Scope of application**

The general contracting conditions can be used both in contracts that regulates relationships of professionals among themselves and also in contracts between them and the consumers. But in both cases the general contracting conditions must be part of the contract. They must be known by the borrower or they must exist with the chance of being known when the contract is written. They must be also drafted in a clear way with clarity, concretion and simplicity.

The Act is generally applicable to all situations in which are predominating the elements of predisposition. Thereby it protects the interests of consumers and users, such as anyone who contracts with any person that has used general contracting conditions to make agreement. This Act is also applied although the protected one is a professional. The

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<sup>14</sup> SPAIN. 1998. Law 7/1998, 13<sup>th</sup> of April, by which is regulated the General Contracting Conditions. Published in BOE, the 14<sup>th</sup> of April of 1998. Article 1.

<sup>15</sup> REYES LÓPEZ, M.J. 2009. Manual of Private Consumption Law. 1<sup>st</sup> edition. Madrid. La Ley.

regulation shall apply accordingly both in relations professionals among themselves and also between them with consumers.

### **3.3. Incorporation requirements.**

To be incorporated as a clause into a contract, it is essential that:

1. "The general conditions will become part of the contract when it is accepted by the adherent his incorporation thereof and when it is signed by all the parties. Any contract should refer to the general conditions incorporated.

It might not be understood that there has been acceptance of the incorporation of general conditions to the contract when the lender (proponent) has not explicitly informed to the borrower (adherent) about its existence and when he has not provided him a copy of them.

2. Adherents may require to the authorizing notary not to transcribe the general conditions of contract in the scriptures that he gives. Borrowers may also require the notary to record the clauses in the matrix, incorporating them as annexed. Here the notary will check that adherents have full knowledge of its contents and that they accept them.

3. When the contract should not be formalized in a written form and the proponent submits a supporting receipt of the consideration received, it will be enough that the proponent announces the general conditions in a visible place where the business takes place. He also should insert the contract documents that go with its celebration; or, otherwise, should ensure the effective bonding possibility of knowing their existence and content at the time of the celebration.

4. The drafting of general clauses must meet the criteria of transparency, clarity, precision and simplicity."<sup>16</sup>

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<sup>16</sup> SPAIN. 1998. Law 7/1998, 13<sup>th</sup> of April, by which is regulated the General Contracting Conditions. Published in BOE, the 14<sup>th</sup> of April of 1998.



### 3.4. Interpretation rules

The rules of interpretation are guided by the provided information of the Civil Code in its articles 1281 and following and in the article 6 of the Law 7/ 1998 of 13 April, about General Contracting Conditions.

First of all, if there is any contradiction between the general contracting conditions with those which have been individually negotiated amidst the lender and the borrower, there will be always imposed the ones individually negotiated between the credit institution and the client. In the case that the provisions disposed in the clauses result more profitable for the client, these will be imposed over the rest.

Secondly, doubts about interpretation in dark general conditions will be solved in favor for the adherent (borrower). In consumer contracts it will be only applicable when they involve individual activities.

The following sections discuss the non-incorporation and invalidity of certain general conditions.

### 3.5. Failure to incorporation and nullity regime

The article no. 7 of Law 1998 of 13<sup>th</sup> of April dictates that *"clauses that the adherent has not had the chance to completely know at the time of conclusion of the contract or when being necessary, in the terms of art.5 not have been signed"* such clauses will be excluded from the contract. It adds that *"the ones being unreadable , ambiguous , obscure and incomprehensible , except in regard to the latter , the ones which have been expressly accepted by the writing of the adherent and the ones which are conformed to specific legislation discipline within its scope the necessary transparency the clauses in the contract"*<sup>17</sup> will be excluded from the contract.

About the nullity thereof, the article no. 8 of the said Act states that *"there shall be null and void the general contracting conditions that produce detriment to the borrower contradicting the provisions of this Act or any other mandatory or prohibitory rule , except that in them there is set a different effect for any offense."*<sup>18</sup> The second paragraph of this article talks about those terms deemed abusive.

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<sup>17</sup> SPAIN. 1998. Law 7/1998, 13th of April, by which is regulated the General Contracting Conditions. Published in BOE the 14<sup>th</sup> of April of 1998. Article no. 7.

<sup>18</sup> SPAIN. 1998. Law 7/1998, 13th of April, by which is regulated the General Contracting Conditions. Published in BOE the 14<sup>th</sup> of April of 1998. Article no. 8.

According to GLDCU, such terms are void. These terms and their regulation will be discussed later on.

Reyes Lopez (2009) states the following about the non-inclusion scheme:

"Regarding the application regime, the judicial nullity declaration or non-incorporation may be requested by the adherent (client according to the regulatory rules of contractual invalidity).

The obtained judgment in a legal process (through the exercise of individual action of nullity or the declaration of non-incorporation) will decree the nullity or non-incorporation of the affected general clauses and will clarify the effectiveness of the contract or will declare the nullity of the contract thereof when the nullity or non-incorporation of those affects one of its essential elements in terms of the article 1261 of the CC"<sup>19</sup>

Among the general conditions of contract, there are certain clauses that have been deemed abusive. Given the different position in the contract that the parties (lender and borrower) are located to each other, it can be fostered an abuse by the financial institution to the consumer. Pursuant with the CC, you cannot leave the validity and the enforceability to the freewill of one party.

### **3.6. Non-individually negotiated clauses.**

In contracts (in this case mortgage loan) between consumers and users, terms not individually negotiated, including the promoted ones by the public administrations and institutions and companies subject to them, must meet the following requirements:<sup>20</sup>

- "Fulfillment , clarity and simplicity in the writing, with the possibility of direct understanding , without forwarding to texts or documents that are not provided prior to or simultaneously with the conclusion of the contract, and that in any case, must be made explicit reference in contractual document.
- Accessibility and readability, in a way that enables the consumer or user the knowledge over its existence and content prior to the conclusion of the contract. In

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<sup>19</sup> REYES LÓPEZ, M.J. 2009. Manual of Private Consumption Law. 1st edition. Madrid: La Ley. P 215.

<sup>20</sup> SPAIN. Royal Legislative Decree 1/2007, of 16th of November, by which is approved the Restated Text of the General Law for the Defense of Consumers and Users and other complementary laws. Published in BOE no. 287, 30<sup>th</sup> of November of 2007. Article 80.

no case this requirement will be met if the font size of the contract script is less than a millimeter and a half or if there is insufficient contrast with the background, which implies difficulties when reading.

- Good faith and fair balance between the rights and obligations of the parties, which in any case preclude the use of unfair terms. "

In other words, the requirements that are outlined in the terms not individually negotiated must be drafted in a way that any consumer or user can understand them. They have to be appreciated clearly at first sight (minimum font size). Finally, they have to be of good faith and have to generate equilibrium between the rights and obligations amidst the parties.

Then, in the next section, it will be detailed what they are and what unfair clauses are and which are the most common types that can be found in mortgage loan agreements.

## **4. UNFAIR CLAUSES**

### **4.1. Definition**

The definition of what unfair clauses are can be summarized in the following article "There will be considered unfair terms all those provisions non-individually negotiated that against the requirement of good faith, they cause, to the detriment of the consumer, a significant imbalance in the rights and obligations of the parties under the contract"<sup>21</sup>

From this definition found in the Restated Text of the General Law for the Defense of Consumers and Users (hereinafter RTGLDCU), anyone can observe what distinguishes general conditions and unfair terms. This is because the two concepts may overlap each other. In other words, in consumer contracts, some of the general conditions stipulated therein may be unfair to them and may be regarded as unfair terms.

Another inference that can be drawn from the definition of unfair clauses is that in order to consider them as unfair it is necessary that they have not been individually negotiated. However, although some terms have been individually negotiated, this does not prevent the application of the law to the other terms of the contract that have not been dealt one by one. "The fact that certain aspects of a term or that an isolated clause have been

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<sup>21</sup> SPAIN. Royal Legislative Decree 1/2007, of 16th of November, by which is approved the Restated test of the General Law for the Defense of Consumers and Users and other complementary laws. It was published in BOE no. 287, 30<sup>th</sup> of November of 2007. Article 10 bis

individually negotiated will not exclude the application of this Article to the rest of the contract"<sup>22</sup>

To declare the unfairness character of a particular clause, the legislation needs to take into account the goods or services covered by the contract, in the conditions in which it has been concluded.

In any case the unfair clauses are the ones that:

- "Links the contract to the will of the employer,
- Limit the rights of consumers and users,
- Determine the lack of reciprocity in the contract,
- Impose the consumer and user disproportionate guarantees or would unduly impose the burden of the proof,
- Result disproportionate in relation to the development and execution of the contract, or
- Violate the rules about applicable competence and law."<sup>23</sup>

## **4.2. Most common types**

Now it is about to try to explain which are the most controversial unfair clauses. These ones are the source of the borrower's problems. Therefore, this paper will provide details of early termination clauses, clause soil and default interest clause.

### ***4.2.1. Early termination clause***

The early maturity of a mortgage loan is an operation performed by the financial institution which consists in rescinding in advance the mortgage loan agreed with the customer. This is done in order to expedite the process to judicially claim any unpaid quotas and so, to

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<sup>22</sup> SPAIN. Royal Legislative Decree 1/2007, 16th of November, by which is approved the Restated Test for the Defense of Consumers and Users and other complementary laws. It was published in BOE no. 287, 30<sup>th</sup> of November of 2007. Article 10 bis.

<sup>23</sup> SPAIN. Royal Legislative Decree 1/2007, 16th of November, by which is approved the Restated Test for the Defense of Consumers and Users and other complementary laws. It was published in BOE no. 287, 30<sup>th</sup> of November of 2007. Article 84.4.

recover the entire debt that remains unpaid. The ACT of Civil Procedure (hereinafter ACT) provides the possibility that the lender has the right to claim all of the debt if the borrower defaults on any of the periodic payments under the contract.

The Law 1/2013 of 14 May states that people who have been affected by legal proceedings initiated on their mortgage have the possibility to invoke the clause as unfair early maturity.<sup>24</sup>

When could be it considered unfair? Until now it was enough that the borrower (the debtor) failed paying a loan quota (usually monthly) for the bank to incur in early termination and begin with the foreclosure proceedings. However, the Court of Justice of the European Union dated March 14, 2013, declared a foreclosure proceeding in which the debtor does not have the possibility of an opposition to this execution pleading that it is an unfair clause. It involved an infringement of the Directive 93/13/EEC of the Council of 5<sup>th</sup> of April of 1993. Such Directive stipulates through its article number 7 that:

"1.The Member States shall ensure that, in the interests of consumers and competitors, adequate and effective means exist to prevent the continued use of unfair terms in contracts concluded with consumers.

2. Means referred to in paragraph 1 shall include provisions which allow people or organizations, under national law, who have a legitimate interest in protecting consumers, to turn up under national law to the competent judicial or administrative bodies. This is in order to enable them whether contractual terms drawn up for general use are unfair and also to apply appropriate and effective means to prevent the continued use of such terms.

3. The resources referred to in paragraph 2 may be directed, subject to national legislation, separately or jointly against a number of professionals in the same economic sector or against their associations which use or recommend using the same general contractual terms or similar terms.<sup>25"</sup>

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<sup>24</sup> SPAIN. Law 1/2013, of 14th of May, is about measures to enforce the protection to mortgage debtors, debt restructuring and social renting. It was published in BOE no. 116 15<sup>th</sup> of May of 2013.

<sup>25</sup> EUROPE. Directive 93/13/ECC of the Council of 5th of April of 1993. Article 7.

That article can be sum up in that consumers are entitled to claim the clauses they considered unfair for the courts to determine whether they are or they are not. This is in order to protect the customer against possible abuses by the financial institution.

#### ***4.2.2. Floor clause***

Financial institutions, when providing mortgage loans at long-term periods, are obliged to cover any possible drop in the interest rate. Thus, that will cut their financial income which comes from the periodic payments made by consumers. Hence, the terms called floor clauses arise.

The floor clauses are the minimum percentage of the reference interest rate (usually the EURIBOR plus a spread) that is applied to the quotas paid by consumers. In addition to the EURIBOR, the interest rate may be subject to financial institution scales or also to independent agencies scales such as the ones of the European Central Bank. Thus, the same consumer cannot make profit of a lowering interest rate that exceeds that limit. However, the benefit of this hedging policy is only for the financial institution that maintains its financial income through the borrower's financial expenses.

Within its commercial policy, the bank also provides a roof clause to protect the borrower from large rises in the interest rate of reference. The problem lies in the great distance between one percentage (floor clause) and the other (roof clause). While the floor clause is usually applied as often the interest is usually less than the established limit in this clause, the top of the ceiling clause is never exceeded since it is such a high percentage that EURIBOR or others often never reach. Financial institutions tend to perform calculations over the interest rates volatility as the EURIBOR and establish a higher percentage than those estimations. That is why it never reaches the kind set out in the roof clause.

For these reasons it is understood that the floor clauses create an imbalance for the consumer. While the borrower does not take advantage for lowering interest rates, the financial institution does throughout establishing roof clause at a rather high level and making profit at the expense of high climb. If a look is taken at the general definition RTGLDCU in its article 82 (cited above), should be considered as unfair the floor clause by failing to balance the risks assumed by each party.

#### ***4.2.3. Default interest clause. Difference between remunerative and default interests.***

First, it should be known and understood the remunerative interests. These interests are those that are charged as capital performance delivered to a third party (the consumer or borrower). All capital that is delivered as a loan or credit, it must generate a yield. You must obtain remuneration for lending the capital to be used by a third party. The lender must obtain a performance, a remuneration for the investment or given on loan.

If such interests were disproportionate, it could be entailed the Usury Law. Its article no. 1 gives the following:

"There are considered usury interest the ones that are over the normal rate of the money and the ones manifestly disproportionate in relation to the circumstances of the case. There are also considered the ones that result unconscionable for the consumer, being motives that they have been accepted by the borrower due to an anguishing situation or due to his inexperience or moreover due to his mental faculties.

The contracts involving an amount received larger than the real delivered, whatever their organization and circumstances are. Inasmuch as this is about somewhat indeterminate concepts, thus raises the possibility of setting a top of interest. From this top in advance the interests can be considered usurious ones."<sup>26</sup>

With the description of unconscionable it is referenced (in the context of a mortgage loan contract) to all the benefits attributed to one party, being the other the one who must satisfy some harsh conditions. In other words, it would be unfair to one party. In this particular case, the other party is the consumer or borrower.

Regarding the name of usurious interest, they acquire this "name" when are superior to the result of applying the standard interest rate (2.5%) indicated in Article 19 of Law of consumer credit of 23th of March of 1995<sup>27</sup> over the legal interest . If for example the legal interest rate was at 4.8%, it would be considered usurious interest from 12 % ( $4.8\% \cdot 2.5\%$ ).

After explaining what the remunerative interests are and when these become unfair, the next step in the list of the most common unfair terms is the definition of default interest.

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<sup>26</sup> Law of 23th of July of 1908, about the nullity of usury loan agreements. It was published in BOE no. 206, the 24<sup>th</sup> of July of 1908. Article 1.

<sup>27</sup> Law 7/1995, of 23th of May, about consumer credit (in force until the 25<sup>th</sup> of September of 2011). It was published in BOE no. 72 the 25<sup>th</sup> of March of 1995. Article 19.

The default interests are the interest rate applicable in a mortgage loan contract, when the consumer or borrower is on default. Arrears is defined under Article 2 of Law 3/2004, of 29 December, as "exceeding the contractual or statutory period of payment."<sup>28</sup>

In that Act, the article no. 5 provides that the mere failure to pay within the legally or established terms, the borrower will be on default. He also must pay the interest agreed in the contract without requiring the lender warning about maturity or any intimation.

In order to claim default interest by the creditor (lender), they would be the following:

- "That he has fulfilled its contractual and legal obligations.
- That he has not received in time the amount owed unless the debtor can prove that he is not responsible for the delay.
- In case that the parties have agreed payment schedules for subscription installments, when any of the installments is not paid at the agreed date, interest and compensation under this Act shall be calculated solely on the basis of the amounts owed."<sup>29</sup>

With regard to default interest to be paid by the debtor, it will be the result of the contract. If there is nothing agreed about that, it will be the statutory rate that the European Central Bank (ECB) states in its most recent refinancing operation before the first day of the calendar quarter plus eight percentage points.<sup>30</sup> This interest rate will be the result in the case of fixed rate auctions. If it were a variable auction procedure rate, the interest rate would be the marginal rate resulting from this auction.

The legal rate of interest for late payment will be applied during six months after fixation. This statutory rate will be published each semester in the BOE by the Ministry of Economy and Finance.

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<sup>28</sup> Law 3/2004, of 29th of December, by which is established measures against defaulting in commercial operations. It was published in BOE no. 314 the 30<sup>th</sup> of December of 2004. Article 2.

<sup>29</sup> Law 3/2004, of 29th of December, by which is established measures against defaulting in commercial operations. It was published in BOE no. 314 the 30<sup>th</sup> of December of 2004. Article 6.

<sup>30</sup> Law 11/2013, of 26th of July, about measures of supporting entrepreneurs and of growth stimulation and of employment creation. It was published in BOE the 27<sup>th</sup> of July of 2013. Article 33.



In addition to the default interest, if the debtor incurs in a delay of payment of any of the installments, the bank is entitled to charge the debtor a fixed 40 euros that will be added to the principal amount. The bank is also entitled to claim compensation from the debtor for all relevant recovery costs and the amount exceeding 40 euros previously expressed.

#### **4.3. Unfair clauses effects: Absolute nullity.**

The TRLGDCU establishes through its article no. 83.1 that: *"Unfair terms will be absolutely null and they will not be written in the contract. For this purpose, the judge, after listening both parties, will declare the nullity of unfair clauses included in the contract. However, the agreement will continue binding the parties if those terms can survive without such clauses."*<sup>31</sup> This involves only partial annulment of the clause or clauses affected. In no way affects the entire contract. It does not affect the legal business.

### **5. COURT OF JUSTICE OF THE EUROPEAN UNION (CJEU)**

In the following sections this paper will try to explain the maximum legal organism at Community level, with their respective roles and influence on the Spanish legislation. It also seeks to show the application of the European legislation on a real case. Such case is the one that changed the foreclosure proceeding in Spain. It is called the "Aziz case".

#### **5.1. Definition and functions**

The Court of Justice of the European Union (hereinafter CJEU), is an institution of the European Union (EU), whose mission is to interpret and execute the law of the European Union in order to ensure its application in all member countries. It solves legal disputes between governments and EU institutions. Moreover, individuals and all kind of

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<sup>31</sup> Royal Legislative Decree 1/2007, of 16th of November, by which is approved the Restated Text of the General Law for the Defense of Consumers and Users and other complementary laws. It was published in BOE no. 287 the 30<sup>th</sup> of November of 2007. Article 83.1.

organizations (companies) can go to the Court if they consider that any EU institution has violated their rights.

The Court is composed of one judge from each member country. Furthermore, it is assisted by eight advocates-general who perform reports on matters faced to the Court. The mandate of both is about six years with possibility of renewal.

Persons or organizations bring actions before the Court, who delivers sentence on them. According to the information obtained from the website of the EU, the five most common procedures are:<sup>32</sup>

- Preliminary rulings: it occurs when national courts have doubts about an EU rule. That is when the CJEU has to interpret that rule in a way that it is applied correctly and equally in all member countries.
- Actions for failure: it happens in the case that a member fails to comply with EU regulations. If the Court appreciates that failure, its judgment will be binding on that country. If then the country does not comply with the judgment, the Court could penalize or fine him.
- Actions for annulment: They can be used by countries, institutions (Council, Commission and Parliament) or by individuals who believe either that a particular standard of EU law is illegal. It can be also when their will is to repeal it
- Actions for failure to act: they arise as a complaint by the member countries, community or private institutions and companies. The claim arises in turn because the Parliament, the Council or the Commission shall not make certain decisions under certain circumstances as required by the Treaty.
- Direct actions: individuals and businesses that file claims for compensation for damage if they have been damaged by the action or omission of the EU or any of its agents.

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<sup>32</sup> EUROPEAN UNION. 2014. [http://europa.eu/index\\_es.htm](http://europa.eu/index_es.htm). Consulting date: 30th of May of 2014. Disposable at: [http://europa.eu/about-eu/institutions-bodies/court-justice/index\\_es.htm](http://europa.eu/about-eu/institutions-bodies/court-justice/index_es.htm)

Below it will be explained the decision of the CJEU in a very recent case. This is the "Aziz case." It has been chosen because it is a fact that it has had high media relevance. Moreover this issue identifies many individuals and families who are in situations similar to those of Mr. Mohamed Aziz.

## 5.2. The “Aziz case”

### 5.2.1. *Background*<sup>33 34</sup>

First, there must be contextualized the origin of all this controversy. Mr. Aziz (Moroccan-born) worked in the construction sector in Martorell (Barcelona). In July 2007, he signed with the bank Caixa Catalunya a mortgage loan contract of 138000 euros for a period of 33 years with monthly payments (quotas) close to 700 euros.

Since 2008, after becoming unemployed, he stopped paying their monthly installments. Since he had formalized the loan until he stopped paying quotas, he had amortized 1325 euros of the principal and 6656 euros of regular interest. After the bank required the payment unsuccessfully, it initiated foreclosure proceedings against Mr. Aziz. The subject did not appear, so that the execution was ordered. Caixa Catalunya claimed a debt of 139,674 euros, plus 41902 euros of default interest and court costs.

After the non-appearance of Mr. Aziz, the execution was ordered. Later, the public auction of the property was taken place without any offer submitted. According to Spanish law, the right was left in the hands of the bank for 50% of its value (about 97,000 euros).

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<sup>33</sup> Court of Justice of the European Union. Aziz case (C-415/11). Judgment of 14th of March of 2013.

<sup>34</sup> EL PAÍS. 2014. *Diario El PAÍS*. <http://elpais.com/> Consulting date: 25th of May of 2014. Disposable at: [http://ccaa.elpais.com/ccaa/2013/05/02/catalunya/1367520137\\_907887.html](http://ccaa.elpais.com/ccaa/2013/05/02/catalunya/1367520137_907887.html)

Just a few days before he was kicked out of his house, Mohamed Aziz had filed a lawsuit asking for nulling a unilateral settlement clause (set by the lender) due to its unfairness. All of this was with the goal of declaring nullity of the foreclosure process that was happening. The Commercial Court No. 3 of Barcelona decided to ask the CJUE about the conformity of Spanish law with the Directive 93/13/EEC over unfair terms.

### ***5.2.2. Court of Justice of the European Union (CJUE) judgment***<sup>35</sup>

In its judgment of 14 March 2013, the CJUE conveyed that the Directive precludes the Spanish legislation because the national law prevents the judge take precautionary measures such as the suspension of foreclosure proceedings. In other words, the judgment concluded that the law under which thousands of people have been evicted from their homes is incompatible with such directive, which aims to protect consumers. Insomuch as the judge who knows the declaratory action cannot suspend the execution procedure, the declaration of nullity can only be produced later. This declaration of nullity ensures mere compensation for damages to the consumer that is not enough. This protection mechanism does not prevent the permanent loss of the property. To sum up, it is only needed that the lender (financial institution) initiates foreclosure proceedings to deprive consumers of the Directive protection.

As the CJUE does not solve national lawsuits, there are the same courts of the Member States who have to resolve such litigations. This statement called the Spanish court to check whether the provisions that the applicant (Mr. Aziz) demanded were abusive. The manager of dictating whether these clauses were unfair or were not was the holder of the Commercial Court no. 3 of Barcelona. This was the Judge José María Fernández Seijo.

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<sup>35</sup> Court of Justice of the European Union. Aziz case (C-415/11). Judgment of 14th of March of 2013.

### **5.2.3. Judgment of the Commercial Court no. 3 of Barcelona**

Following the CJUE judgment in what it was urged the national body to act on its own , the rapporteur of the commercial court no. 3 of Barcelona, the Judge José María Fernández Seijo, proceeded to consider the clauses that could be considered unfair within the Mr. Aziz's contract.

First, the default interest clause. The sixth financial condition on the mortgage loan script provided that the borrower (Mohamed Aziz) would incur in default automatically (without any summons or complaint) if he failed to pay on the due date, even by early maturity, any amount owed by interest or amortization. The default interest was 18.75%, and they were automatically applied with respect to amounts not paid on the due date without requiring them to be claimed by the entity. Following the judgment of the CJUE, within the legislative and judicial discussion, it was considered that any default interest bigger 2 or 3 times than legal interest rate (around 12 % in 2007) should be considered abusive. Additionally, if this default interest far exceeds the damage caused by such default (delayed payments) should also be considered abusive. Due to the large difference between the default interest established (18.75 %) and the legal money multiplied by three (12%), the Judge Seijo declared abusive interests because they were disproportionate and because there was a mistake in its calculation.

After this, the turn was for the early termination clause. The sixth bis clause on the writing said the lender could urge an early termination of the mortgage loan if any of the deadlines set expired and the debtor had not complied with the payment of the quota. The judgment of the CJUE ruled that *"there should especially check if this power depends on that the consumer has failed to fulfill an essential obligation of the contract and if the nature of the breach is sufficiently serious regarding the duration and the amount of the loan."*<sup>36</sup> According to Fernandez Seijo, that clause is null since Mohamed Aziz had only delayed their payments few times. Seijo calified as grave that the debtor failed to pay 4 installments *"although such failure could be expected according to the data available to the financial institution in respect of assets and income."*<sup>37</sup> This default could have been foreseen by the entity as it was fully aware of the economic situation of the borrower.

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<sup>36</sup> Court of Justice of the European Union. Aziz case (C-415/11). Judgment made the 14<sup>th</sup> of March of 2013.

<sup>37</sup> General Council of Judiciary. 2013. <http://www.poderjudicial.es/> Consulting date: 31-5-2014. Disponible at: [http://www.poderjudicial.es/cgpi/es/Poder\\_Judicial/Noticias\\_Judiciales/El\\_juez\\_de\\_Barcelona\\_declara\\_abusivas\\_clausulas\\_del\\_contrato\\_del\\_caso\\_Aziz\\_origen\\_de\\_la\\_sentencia\\_del\\_TJUE\\_sobre\\_el\\_sistema\\_de\\_ejecucion\\_hipotecaria](http://www.poderjudicial.es/cgpi/es/Poder_Judicial/Noticias_Judiciales/El_juez_de_Barcelona_declara_abusivas_clausulas_del_contrato_del_caso_Aziz_origen_de_la_sentencia_del_TJUE_sobre_el_sistema_de_ejecucion_hipotecaria)

The applicant received a monthly wage of about 1000 euros. From these euros, the 70% (700 euros) of them were destined to pay the mortgage payments. The borrower had failed to pay only 453 euros for principal, it is to say, the 0.328 % of the total amount borrowed when the lender (Caixa Catalunya) proceeded to the termination of the mortgage loan. Even adding the remunerative interests, the percentage of unpaid debt remained being so small.

Finally, the last sentence was about the clause relating to the unilateral liquidation of the defaulted debt. The Paragraph e) of the clause (with the title: claimable debt) indicated that, in order to claim the debt and for the foreclose process, it's agreed that the moneylender accompanied by the mortgage constitution draft may present the liquidation, which will be practiced according to the agreed manner throughout the corresponding certificate with the amount demanded. This gathered that the bank could directly present liquidation of the amount to initiate foreclosure. The judgment urged the judge to appreciate if the clause makes it difficult for the consumer to have access to justice and to do his opposition exercise (the defense). Indeed, unilateral settlement clause limited Mr. Aziz's the disposition of procedural means . For this reason the judge Seijo declared unilateral liquidation clause as unfair. Such term, in turn, was disabled due to if it is considered that the two aforementioned clauses (the early maturity and default interests) are unfair, the last one is incorrectly performed.

In the ruling written in the Seijo's judgment, there are declared as nulls the previously explained unfair clauses. The consequence of this ruling is that the amount claimed in the process of execution by the Caixa Catalunya was no liquid in the terms and amounts demanded in the complaint. The judge concluded that each party would have to face their own expenses and that there could file an appeal within 20 days since the notification of this judgment.

## 6. CONCLUSIONS

1<sup>st</sup>. Unfair terms, according to their definition, are those that are not clear, understandable or individually negotiated that cause a consumer detriment. It is added to this definition that the consumer would not have agreed them in an equitable negotiation.

2<sup>nd</sup>. Unfair terms have been in the general contracting conditions, that is to say, in adhesion contracts written by the financial institution. They are clauses that are not negotiated individually so they are preset by the bank or savings bank.

3<sup>rd</sup>. According to the above conclusion there are certain clauses that are now branded as unfair. These ones are often repeated in the far majority of contracts with mortgage guarantee signed with consumers. The main ones are the early maturity one, the default interest one and the floor clause.

4<sup>th</sup>. The early termination clause is null due to its unfairness. It is because the lender may encourage early resolution of the mortgage if any of the deadlines set expire and the debtor does not comply with the payment of the quota. In most of the cases the percentage of unpaid debt was laughable.

5<sup>th</sup>. The default interest clause is null because of its unfairness. In Aziz's case, it far exceeds two or three times the legal interest rate. In such case, the difference was 6.75 %.

6<sup>th</sup>. The floor clause is null because its unfairness. It is due to the non-information given to the consumer about the more than possible lowering of the interest rate under the established rate of the clause. Moreover, it is null due to the great difference that exist with the ceiling clause (limit that was foreseen that there will not be overcome). Such facts produce a profit for the moneylender and a detriment for the borrower.

7<sup>th</sup>. Regarding the legislation, there was an inconsistency between the Spanish and European legislation with its Directive 93/13/EEC. The Spanish law prevented the judge act officially in foreclosure proceedings to examine whether there were unfair clauses in the mortgage loan agreement or not. This undermine the borrower, since he could only act retrospectively being able to obtain in the best case a compensation for damages that do not compensate the loss of the property. After the judgment of the CJUE in March 2013 regarding the Aziz case, Spanish judges began to intervene in the foreclosure proceedings.

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